OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum
Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer = .

O = .

R =

U =

V =

Date =

Year 1 =

Year 2 =

Year 3 =

Year 4 =

Year 5 =

Year 6 =

Year 7 =

Year 8 =

State =

ISSUE:

Whether for purposes of computing the net operating loss (NOL) carryforward under I.R.C. § 172(b)(2), taxable income must be reduced by the special deduction provided by I.R.C. §833(b).

CONCLUSION:

The net operating loss carryover is computed after reducing taxable income by the special deduction provided by I.R.C. §833(b).

FACTS:

Taxpayer is the successor in interest to both O, which did business as R, and U, which did business as V. R and V were consolidated into Taxpayer in a statutory consolidation under State law on Date. Briefly stated, the Taxpayer became a taxable entity in Year 1 following enactment of changes applicable to Blue Cross/Blue Shield organizations in the Tax Reform Act of 1986. R was a Blue Cross organization subject to I.R.C. § 833 and was a member of a life/non-life consolidated group during the tax years at issue. In Year 1 and Year 2, R sustained net operating losses which were not utilized in Year 1 or Year 2, producing NOL carryovers to Year 3 through Year 8.

As a Blue Cross/Blue Shield organization, the Taxpayer was entitled to the special deduction provided under I.R.C. § 833(a)(2). In calculating the special deduction on its federal income tax returns for Year 3 through Year 7, Taxpayer determined the taxable income cap of I.R.C. § 833(b)(2) without first taking into account the NOL carryforward from Year 1 and Year 2.

Taxpayer computed gross income and then subtracted only those items permitted to be deducted in computing "separate taxable income" under Tres. Reg. § 1.1502-12. In its calculation of consolidated income, Taxpayer did not include items taken

into account in the calculation of consolidated taxable income, namely the NOL, charitable contribution, and dividend received deductions. Taxpayer did, however, include the I.R.C. § 833 special deduction. Taxpayer then added the separate taxable income of the various members. Consolidated net operating losses were reported for Year 3 through Year 6; no taxable income was reported; and, thus, the consolidated items, including its consolidated NOL, charitable contribution and dividend received deductions were not utilized for those years.

LAW AND ANALYSIS

I.R.C. § 833 treats Blue Cross and Blue Shield organizations as stock property and casualty (P&C) insurance companies subject to Part II of Subchapter L of the Internal Revenue Code. I.R.C. § 833(a)(1). I.R.C. § 833(a)(2) (special deduction) provides that a special deduction for any taxable year shall be allowed as determined under subsection (b).

I.R.C. § 833(b)(1) provides that the deduction for any taxable year is the excess (if any) of (1) 25% of the sum of (i) claims incurred during the taxable year, and (ii) expenses incurred in connection with the administration, adjustment, or settlement of claims over (2) the "adjusted surplus" as of the beginning of the taxable year.

I.R.C. § 833(b)(3) defines the term "adjusted surplus". For a BCBS in existence prior to Year 1, such as Taxpayer, I.R.C. § 833(b)(3)(B) defines the adjusted surplus at the beginning of the organization's first taxable year beginning after December 31, 1986, as its "surplus" at that time. For that purpose, the term "surplus" means “the excess of the total assets over the total liabilities as shown on the annual statement.” I.R.C. § 833(b)(3)(B). For subsequent years, the adjusted surplus as of the beginning of any taxable year is an amount equal to the adjusted surplus as of the beginning of the preceding taxable year (i) increased by the amount of any adjusted taxable income for the preceding taxable year, or (ii) decreased by the amount of any adjusted NOL for the preceding taxable year. I.R.C.§ 833(b)(3)(A).

I.R.C. §833(b)(2) contains a limitation on the deduction available under I.R.C. § 833(b)(1), providing that the special deduction available in any taxable year shall not exceed taxable income for that year, determined without regard to the special deduction. Under I.R.C. § 833(a)(1), the starting point for determining the taxable income cap of I.R.C.§ 833(b)(2) is Part II of Subchapter L.

All P&C insurance companies, including BCBS, are subject to I.R.C. § 831(a) which imposes tax on the taxable income of an insurance company subject to Part II of Subchapter L of the Code. “Taxable income” is defined under I.R.C. § 832(a) to mean gross income as defined in I.R.C. § 832(b)(1) less the deductions allowed by subsection (c). Among the items taken into account in deriving taxable income are

the NOL deduction of I.R.C. § 832(c)(10), the charitable contributions deduction of I.R.C. § 832(c)(9), and the dividends received deduction of I.R.C. § 832(c)(12).

A BCBS must apply the rules of I.R.C. § 832 to derive its taxable income in order to determine the maximum special deduction available during the taxable year. Accordingly, pursuant to I.R.C. § 833(b)(2), the taxable income limitation on the special deduction for an unconsolidated taxpayer is calculated after all deductions permitted under I.R.C. § 832(c) but without regard to the special deduction itself. Therefore, taxable income, as that term is used in I.R.C. § 832(b)(2), is determined by reducing gross income by the deductions available to a P&C company, including the NOL deduction, the charitable contributions deduction and the dividends received deduction. This approach follows the specific wording of the statute which requires using taxable income, modified only to disregard the special deduction, as the limitation on the special deduction.

The amount of the deduction under I.R.C. § 833(a)(2) is capped by a number of limitations. The limitation at issue here is in I.R.C. § 833(b)(2), which limits the deduction to taxable income. For the years after Year 2, if the NOL carryovers are taken into account in determining taxable income before the special deduction is computed, the Taxpayer would have no taxable income and would therefore not be entitled to special deductions for those years, thus reducing the NOLs that could be carried forward and used in later years. On the other hand, if the NOL carryovers are not taken into account, the Taxpayer would have taxable income (for purposes of the limitation) and would thus be able to take a special deduction for the later years and thereby increase the amount of NOLs usable in subsequent years. To get the answer to this question, it is necessary to analyze the “absorption rule” relating to NOL carryovers.

I.R.C. § 172(b)(2) provides that the entire amount of the NOL for any taxable year ("loss year") is carried to the earliest of the taxable years to which such loss may be carried. Under the absorption rule, the portion of the loss that is carried to each of the other taxable years is the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which the loss shall be carried. Under I.R.C. § 172(b)(2)(B), the taxable income for any such prior taxable year shall be computed by determining the amount of the NOL deduction without regard to the NOL for the loss year or for any taxable year thereafter.

Treas. Reg. § 1.172-5 interprets the absorption rule for taxpayers whose deductions are limited to a percentage of taxable income. Under Treas. Reg. § 1.172-5(a), the taxable income for any year that is subtracted from the NOL for any other year to determine the portion of the NOL that is a carryback or a carryover to a particular year is computed with the modifications described. The regulation specifically provides that the modifications must be made independently of, and without reference to, the modifications required for purposes of computing

the NOL itself. Under Treas. Reg. § 1.172-5(a)(2)(i), the NOL deduction for the taxable year is computed by taking into account only the NOLs otherwise allowable as carrybacks or carryovers to the taxable year as were sustained in taxable years preceding the taxable year in which the taxpayer sustained the NOL from which the taxable income is to be deducted. Thus, for such purposes, the NOL for the loss year, or any year thereafter, is not taken into account.

Under Treas. Reg. § 1.172-5(a)(2)(ii), unless otherwise specifically provided, any deduction that is limited in amount to a percentage of the taxpayer's taxable income is recomputed upon the basis of the taxable income determined with the prescribed modifications, i.e., without regard to the NOL. In other words, if a taxpayer is otherwise entitled to a deduction but the deduction is limited by a percentage of taxable income, and the taxable income is reduced by virtue of an NOL carryover, then the taxpayer can use the deduction for the limited purpose of determining how much of the taxpayer's NOL is absorbed in that year, although the taxpayer cannot use the deduction for purposes of generating an NOL that can be carried into a subsequent year.

The issue here is whether a deduction that is limited to taxable income is a "deduction limited by a percentage of taxable income" for purposes of the regulations. If the answer to this question is negative, then no special deduction is taken into account for purposes of the absorption rule. If the answer is affirmative, then the deduction is taken into account, for purposes of the absorption rule, as if there were no NOL deduction.

Because a deduction limited by "taxable income" is a deduction limited by a "percentage of taxable income", it is thus covered by the regulation. Accordingly, such deductions must be taken into account as if there were no NOL for purposes of the absorption rule. The following example illustrates this point:

In Year 1, the taxpayer has a NOL of 100x dollars that it properly carries forward to Year 2. In Year 2, the taxpayer, without taking into account either the special deduction or the NOL carryforward, would have had income of 40x dollars and would be entitled (because of other limitations in § 833) to a special deduction of 25x dollars. Because of the NOL carryforward, the taxpayer has no taxable income for Year 2 and is therefore not entitled to the special deduction. However, for purposes of the absorption rule, only 15x dollars, and not the entire 40x dollars, is considered absorbed in Year 2. As a result, 85x dollars, and not 60x dollars, is available to be carried over to Year 3 and later years. As noted above, this position is supported by a literal reading of Treas. Reg. § 1.172-5. See Rev. Rul. 76-145, 1976-1 C.B. 68.

Accordingly, the Taxpayer can compute the special deduction reducing its taxable income (possibly down to zero) and then apply its NOL carryovers as described in the regulation.

This analysis is unaffected by the fact that this case involves a consolidated group for which different NOL computations might be made under the consolidated return regulations.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted] Our conclusion is consistent with a prior technical advice in which the National Office considered the issue of whether the special deduction or the NOL carryover is used first in a particular year and did not address how much of a NOL carryover is absorbed in a year in which a special deduction is also available.

JOEL E. HELKE
Branch Chief
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